Internal Revenue Service

memorandum

CC:INTL:162-91
Br2: JFeldman

date: FEB 13 1991

to: Nancy B. Herbert
International Special Trial Attorney CC:C

from: Associate Chief Counsel (International) CC

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subject: [redacted] - section 936 (h) election

This memorandum is to follow up your telephone conversation with Christine Halphen, Carol Doran Klein and Jack Feldman on February 5, 1991.

Specifically, we believe that [redacted] is subject to section 936 (h) since the products that it sells in Puerto Rico involve both manufacturing and marketing intangibles. [redacted] is subject to section 936 (h) (1) -(4) since the conditional election to use section 936 (h) (5) was not a valid election. The taxpayer did not indicate the product or products to which section 936 (h) (5) would apply nor did the taxpayer indicate whether cost sharing or profit split would be elected. Since the conditional election was intentional rather than inadvertent, section 9100 relief would not be available. In the absence of an election out under section 936 (h) (5), the taxpayer's benefit under section 936 (h) (1)-(4) would be limited to a cost plus benefit on the conversion costs. The taxpayer would not be entitled to any benefit with respect to any intangible.

If cost sharing were elected, it is possible that the covered intangible exception under section 936 (h) (5) (C) (i) (II) might apply if all of the intangibles were covered intangibles. This would appear to be unlikely in light of the taxpayer's making a conditional rather than a cost sharing election. In the absence of a cost sharing election the covered intangible exception cannot be utilized. The exception is statutory and applies only if the taxpayer has made a cost sharing election. An earlier Bill contained the provisions of section 936 (h) (1) -(4) and a covered intangible exception. It was never enacted into law. The statute which was enacted permitted an election out under section 936 (h) (5) and specifically limited the covered intangible exception to taxpayers electing cost sharing with respect to the product. In comments to the proposed regulations under section 936 (h) taxpayers suggested that the cost sharing election be extended to taxpayers not electing cost sharing. This was rejected by the Service since the

suggestion was believed to be contrary to the statute. A discussion of the issue and the reason for its rejection appears in the preamble to the final regulations under section 936 (h).

Finally, it should be noted that the position advocated by [redacted] in his letter to Jack Feldman, dated May 14, 1984, that intangible property developed by another corporation solely in Puerto Rico and then transferred to a section 936 corporation should be treated as a covered intangible would be incorrect even if a cost sharing election were in fact made. In PLR 8548029, a copy of which is attached, the Service has taken a contrary position holding that "development by one corporation" is not a tax attribute that is carried over to another corporation even in a tax-free asset acquisition to which section 381 (a) applies.

We, therefore, believe that the taxpayer must compute its section 936 benefit under section 936 (h) (1) -(4) as provided under § 1.936-4.

In the tax return schedule attached to your letter, we note that the taxpayer is taking exception to § 1.861-8 (e) (6) and § 1.861-8 (g), examples (25) and (26) and is allocating all of its state income and franchise taxes to U.S. income. Our position is obviously that those regulations are valid and, therefore, you should pursue that issue. The regulations were issued in temporary and proposed form in 1985 and were applicable in the 1987 and 1988 years.

Steven R. Lainoff

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Attachment